

MARKET INSIGHT REPORT

Rentiers Are Headed for Trouble, but Who Are They?

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By John R. Taylor, Jr.

Chief Investment Officer



The world is currently overwhelmed with debt, but underwhelmed with growth. Everyone is trying to export, but no country has embraced the concept of expanding domestic consumption. Although I personally like consumption, I am an American and therefore over-borrowed and unable to service the debt loads of my city, my state, and my country, not to mention my own personal debt load. With the Americans no longer available as consumer of the last resort, and no one else stepping up, global final sales will stagnate in the years ahead. As a result, global debt loads will become relatively larger. If the world economic pie can not grow strongly, thereby lessening the relative size of global debts, the magic of compound interest will certainly bankrupt many governments and commercial entities. Currently there is a growing solvency crisis impacting many Eurozone sovereigns and another one that is occurring within many states and jurisdictions in the United States. It seems quite obvious that many of these problems will lead to default and the loss of principal on a grand scale. In the next few years, a greatly increased percentage of all outstanding investment grade global debt will default.

Historically, whenever debt levels have become overwhelming, countries defaulted on their debt, often by killing the bankers or by changing the terms of the debt. Kings came up with many nefarious schemes to escape the burden of repaying the debt they owed, but they had an advantage that modern governments do not have. The people that owned the debt in the old days were identifiable; Karl Marx referred to them as the *rentiers*. They were the ones who lived by clipping coupons, doing no work; they were the leeches that lived off the work of others. The *rentiers* were not only the 'sometimes' enemies of the king and his court, but they also were the 'constant' enemy of the working masses and the middle class. As such they could be singled out by the authorities and persecuted or robbed without much fear. Some European monarchs like Philip IV defaulted many times, but continued their aggressive (military) spending policies. Modern democratic governments bound by the rule of law might find it hard to be so creative, but that is not the biggest restriction indebted governments face. They can't identify the bad guys, Keynes' "functionless investors." Who are those who benefit from this passive income, today's *rentiers*? They are not the owners of the banks like the ultra-wealthy JP Morgan or John D. Rockefeller owner of Standard Oil, as people of this type now hold only a tiny percentage of the outstanding debt. The owners of the debt are us, the vast middle class. We public and private pensioners and life insurance holders are the ones who are the *rentiers*. About 30% of US GDP can be classified as passive. European numbers are similar. And, now that more and more of us are at retirement age, we are expecting to live on our savings. Our retirement income might look like an entitlement to some, but to us it is our right. What happens next?

In 2010, the authorities seem to have only two choices: allow defaults, which lead to deflation and tremendous stress to the political system and public order; or inflate so that debts lose their significance, which eventually leads to hyper-inflation and tremendous stress to the political system and public order. Growth is a theoretical way out of this dilemma, but with shrinking populations and increased regulation, Europe cannot manage this option. The US might, but the way will be difficult. Cascading defaults will strip away many entitlements upsetting the *rentiers* and those who had planned to become *rentiers* in the future. Countries that choose to allow defaults will see their currencies rally as there will be a shrinkage of currency outstanding increasing the value of the rest, but collapsing equity markets will test their resolve at every turn. We *rentiers* will be lucky if we can enjoy our dotage.



CURRENCY – Commodity Currencies Long-Term View

The Reign of the Commodity Currencies is Ending

By Jonathan Clark

Following the end of the 2001 recession, the markets turned more and more positive about the global economy. Housing markets boomed around the world and business investment was extremely strong, especially in China. This led to a shortage of some commodities and prices rose dramatically. Part of the rise was due to speculation and the low cost of money which resulted from liquidity injected by the central banks. Even pension funds and other institutional investors were advised that commodities should be up to a third of their portfolios as it would add to return, strengthening when equities and bonds were falling. This speculative stockpiling of commodities drove prices strongly higher. Our long-term rate-of-change measure went into overbought territory for nearly 5 years. But now the situation has changed. A combination of fiscal austerity and low consumer demand means commodities will settle back to levels in line with the cost of production, something that will be negative for commodity prices and commodity exporters.



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The Australian dollar collapsed between July and October of 2008 and then during the subsequent 13 months regained 89% of its losses. By way of contrast the CRB commodity index only regained 34% of its losses before peaking in January. The main reason for this Australian strength was optimism about Chinese growth. The RBA also embarked on a tightening monetary policy in October of 2009. Now, concerns are growing about the engineered slowdown of the Chinese economy and we believe that interest rates in Australia will not be hiked before the second quarter of next year.

AUD/USD has been unable to surpass a combination of the downtrend resistance from its historic peak in 1974 or the 50% retracement from this high to the low in 2001. The cycles call for the Aussie to decline into Monday and then rally into late next week and this should be a significant peak. **It should hold below the .8900 area and this should be the right time to sell.** Following this peak it should decline into the week of July 19. A close below .8515 will signal that the Aussie has begun a sustained downtrend lasting into September or October and our initial target will become the .7900 area and it will probably fall much further. This should be the first step of a multi-year decline.